China Controlled Inflation in 1996

China's Government succeeded in reducing inflation to single-digit levels in 1996 while maintaining one of the fastest GDP growth rates of any major economy. With weak external demand, domestic demand led economic growth last year. However, China's foreign exchange reserves continued to increase; the trade surplus with the United States widened, and imports from the European Union and Japan fell, while exports to these two regions increased. As the austerity measures used to reduce inflation aggravated problems in the state sector, the country's state-owned enterprises in 1996 registered their poorest performance since 1949 with nearly half losing money. The strategic position of the large- or medium-sized state-owned enterprises in China—providing urban employment and contributing government revenue through taxes—are two of the main reasons the government is cautious in reforming this sector. [Xinshen Diao, (202) 219-0690]

China's Government succeeded in reducing both growth and inflation to single-digit levels in 1996. Gross Domestic Product (GDP) increased by 9.7 percent in 1996, a lower rate than those of former years, but still one of the fastest growth rates of any major economy. Central government leaders over the past 3 years have made progress in dampening inflation caused by dramatic economic expansion. The officially announced inflation rate (measured by retail prices) was 6.1 percent in 1996. It was the first time since 1991 that China's annual inflation rate fell to a single-digit number and lower than the GDP growth rate.

Domestic demand led economic growth last year, but external demand was weak. In contrast with the stunning gains in the export sector during the previous 2 years, China's exports only grew by 1.5 percent to $151 billion in 1996. Imports grew by 5.1 percent and reached $139 billion in 1996. The slowdown in import growth reflected reduced demand for some commodities as well as government-mandated restrictions over some types of imports. Although exports grew slower than imports, China still ran a $12.3 billion foreign trade surplus in 1996, which was the third consecutive year for China to have an external trade surplus. China's foreign exchange reserves reached $105 billion at the end of 1996, $31.4 billion more than at the beginning of the year.

Improvement in Macroeconomic Performance

Over the past 3 years, inflation has been the most pressing macroeconomic issue for China's top leaders. Accordingly, the government tightened credit and fixed investment spending in 1995. By mid-1996, the growth in the retail price index, the most often quoted number for inflation, dropped from double-digit levels to 7.1 percent.

Although the government succeeded in engineering a "soft landing" for the economy by mid-1996, the fiscal and monetary austerity measures exacerbated the financial difficulties of the state industrial sector. Having achieved a "soft landing" and prompted by growing problems in the state industrial sector, in mid-1996 the central government decided to cut interest rates and bank deposit and lending rates, gradually loosen credit restrictions, and increase working capital loans. These three policies signaled a broader credit easing and stimulated a modest rebound in fixed capital investment during the second half of 1996. Annual fixed investment rose by 18.2 percent in 1996, slightly higher than 1995.

Compared with other countries in the world, China has high rates of investment. In 1996, its fixed investment with respect to GDP was about 35 percent, while the world average rate was around 20 percent. Also, China's household savings with respect to their incomes were quite high. In 1996, China's urban and rural resident domestic savings deposits increased by 30 percent, equivalent to 13 percent of gross domestic products (figure 1).

Growth of government revenues was faster than the growth of the expenditures by 2 percentage points in 1996. The tax reforms introduced in 1994 are beginning to yield greater benefits to Beijing, and half of the state revenues were generated by consumer and value-added tax receipts. The government deficit was 54.8 billion renminbi (RMB) yuan in

Figure 1
Changes in China's personal savings deposits

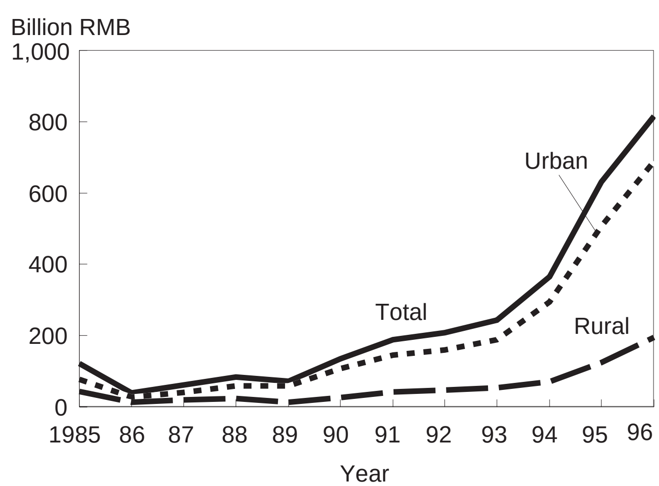


Table 1--China's macroeconomic indicators, 1995-96

Indicator	Units	1995	1996
Population	millions	1,211.2	1,223.9
GDP growth	percent	10.2	9.7
GDP 1/	US$ billion	657.8	816.8
Change in CPI	percent	14.8	6.1
Currency in circulation	US$ billion	95.0	106.0
Total state revenue	RMB billion	624.2	736.6
Total state expenditure	RMB billion	682.4	791.4
State budget deficit	RMB billion	58.2	54.8
Fixed asset investment	US$ billion	241.0	285.0
Exports	US$ billion	148.8	151.1
Imports	US$ billion	132.1	138.8

1/ GDP is in current prices.
Sources: China Statistical Yearbook, 1996; China Monthly' Statistics, Dec. 1996 and Jan. 1997.

1996, smaller than in 1995. The U.S. dollar/RMB exchange rate in 1996 was 8.3 which was the same as the previous year.

Enlarging Trade Surplus with Major Trade Partners

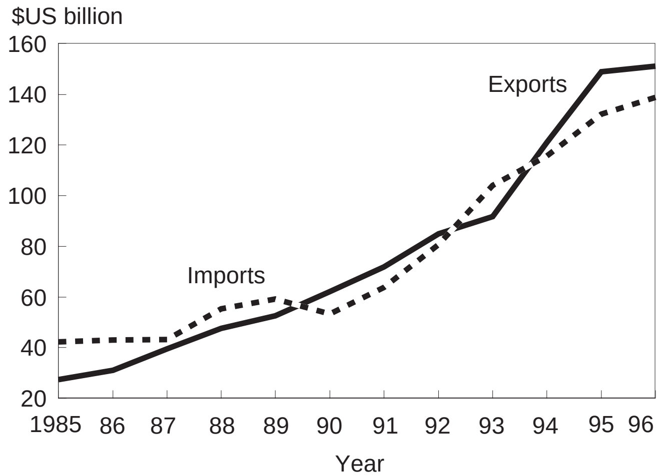
While China's total imports rose more than its exports, its exports to the three major trade partners grew faster than its imports from these economies in 1996. China widened its trade surplus with the United States, reduced its imports from the European Union (EU) and Japan, and increased its exports to these two regions in 1996. Japan remained China's largest trade partner for the fourth consecutive year. Sino-Japan bilateral trade volume hit a record $60 billion, or 20.7 percent of China's external trade in 1996. China shipped $30.9 billion worth of commodities to Japan in 1996, up 8.4 percent from 1995, while its imports from Japan amounted to $29.2 billion, almost the same as in 1995. Fast growth in export and stagnant imports resulted in a small surplus in Sino-Japan trade, which was the first time in the last 5 years that China imported less from Japan than it exported to Japan.

As Sino-Hong Kong trade slipped in 1996, the United States became China's second largest trade partner. In 1996, Sino-U.S. trade reached $63.5 billion according to U.S. Census trade statistics, while the U.S. trade deficit with China widened to $39.5 billion. The fast growth in China's exports to the United States, plus stagnant China imports from the United States, are main reasons for the widening U.S.-Sino trade deficit in 1996.

Sino-EU trade kept almost at the same level of 1995's $40 billion. While EU-bound China exports rose by 3.6 percent from 1995 to $19.83 billion, imports from the EU fell by 6.5 percent to $19.87 billion in 1996. By reducing its imports, China balanced its trade with the EU in 1996. In 1995, China had a $2-billion trade deficit with the EU.

Foreign investment in China's enterprises continued to be a key driver in China's external trade. China sharply cut its tax rebates on exports in 1996, the second reduction in the last 2 years, which hurt some foreign firms working there. But those firms in processing trade got a boost from new tax exemptions on imported materials for processing and

Figure 2
China's total exports and imports



assembling. Exports of joint-venture enterprises surged by 31 percent and reached $61 billion, while imports by these enterprises increased by 20 percent and reached $76 billion in 1996. It is the first time that China's processing trade, i.e., trade involving items imported by joint-venture enterprises for some work or assembly and then re-exported with value added, exceeded its general trade category and accounted for slightly more than half of China's total foreign trade in 1996.

In 1996, China announced that under the "current account" its currency, RMB, is fully convertible. This allows anyone doing business with China, or within it, to covert domestic earnings into foreign exchange or vice versa. The currency is not fully convertible under the "capital account."

Growth by Sector

The value of China's industrial output increased by 15 percent in 1996, down 5 percentage points from the growth rate of 1995, the lowest since 1992. The national industrial value-added figure reached $344.3 billion in 1996, an increase of 12.7 percent in real terms from the previous year. While one-third of industrial output is still from state-owned enterprises, growth of state-owned enterprises' production was much slower than those of the other types of firms. Growth of output from state-owned enterprises was 6.7 percent, whereas output from collectively owned enterprises increased by 23.6 percent, and increased by 18.6 percent for other types of firms — primarily Sino-foreign joint ventures, foreign-funded firms, and private enterprises.

The country's state-owned enterprises in 1996 registered their poorest performance since 1949 with nearly half losing money. The poorest performers include forestry, textile, coal, machinery, and weapons industries. Reform of state-owned enterprises remains the core of economic reform. While the government grants small state-run enterprises more freedom and encourages them to use markets, problems encountered in China's ongoing state-owned enterprise reform are difficult to resolve for large- and medium-sized enterprises. While experimental work in a number of large- and medium sized state-owned enterprises has been in full swing for more than 2 years, most of large and medium-sized enterprises are still tightly controlled by either central or local governments.

Unemployment in the state sector rose in 1996. The State Statistical Bureau reported that those who registered as unemployed amounted to 3 percent of the labor force in the state sector, but actual unemployment is believed to be much higher, as the number of state-owned enterprises operating at a loss increased. Real unemployment and underemployment in Shanghai, the largest city of China, was estimated at between 15 and 20 percent. The World Bank acknowledges that its estimate that redundant workers (who are still registered with the state enterprise) account for more than 10 percent of the workforce at most state enterprises is conservative. A bloated workforce weighs down many potentially profitable firms. In addition, more than 120 million transient laborers from rural areas have rushed into the country's cities in the past 10 years. This accounts for nearly 10 percent of the country's population, and will further increase the supply of workers in the urban areas of China.

Growth Potential During 1997 and Beyond

The easing of credit that started in the second half of 1996 is expected to further stimulate investment in 1997. Despite recent debates on whether the Asia growth story is at the end, China is at an expansion stage of a new economic cycle and will continue to enjoy benefits from its successful economic "soft landing" in 1997. Its GDP growth likely will be up 11 percent. Inflation will still be in the one-digit category. Exports and imports will likely continue their moderate growth in 1997.

July 1, 1997 will be the first day for the People's Republic of China to reclaim sovereignty over Hong Kong. While many disagreements remain between China and the British Government, a smooth transition is expected at least for the short-run. Given the current healthy economy and business confidence level in Hong Kong, there is not great concern that the Hong Kong dollar and the stock market will collapse.

China's long term economic outlook is inseparable from the future of its state-owned enterprises. While prospects for other parts of the economy remain bright, problems in the state sector, especially in the large- or medium-sized state-owned enterprises, persist. Large state-owned industrial enterprises accounted for less than 1 percent (4,600) of the total number of industrial enterprises. But in 1995, they produced 37 percent of the nation's industrial output and generated 42 percent of total value-added tax to the government. Given such a strategic position in the economy, the government will continue to show caution in reforming large- or medium-sized state-owned enterprises.

Another long term problem is the rising unemployment rate. State-owned enterprises provide more than two-thirds of urban jobs. Workers in such enterprises rely on their employers, not only for wages, but also for housing, medical care, retirement benefits, children's education and other services. Increases in the number of unemployed and laid-off workers, as well as those awaiting work with the increase in the number of state-owned enterprises operating at a loss, will put enormous pressure on the economy and become a major destabilizing factor in China's society. This worry is one of the biggest reasons why China's leaders appear to hesitate to undertake deeper reform in state-owned enterprises, and are reluctant to close money-losing state-owned factories until it can knit together a welfare net, including improvements in unemployment insurance coverage and reform of other social security systems, to care for laid-off workers. This analysis suggests that substantive changes to the state sector will remain a reform goal for years to come.

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